89-1613

No.

In The

Supreme Court of the United States

October Term, 1989

R. RICHARD BASTIAN, III, B.P. LOUGHRIDGE, M.D., RONALD D. ROTUNDA, MARCIA ROTUNDA, GENERAL SYNERGY INVESTMENTS, GABRIEL FERNANDEZ, J. MAHAR, CMF ASSOCIATES, ALFRED J. HENDRON, JR., and M.T. DAVISSON,

Petitioners,

vs.

PETREN RESOURCES CORPORATION, an Illinois Corporation, FAESTEL INVESTMENTS, INC., an Illinois Corporation, DAVID J. FAESTEL, and McDERMOTT, WILL & EMERY, a Partnership,

Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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QUESTIONS PRESENTED

1. Whether defrauded investors, in order to recover for violations of §10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5, must allege "loss causation", *i.e.*, that the defendants' fraudulent conduct directly caused a subsequent decline in the value of their investment.

2. Whether defrauded investors, in order to recover for violations of §1962 of the Racketeer Influenced and Corrupt Organizations Act, must allege facts showing that the defendants' fraud directly caused a subsequent decline in the value of their investment.

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The petitioners, R. Richard Bastian, III, B.P. Loughridge, M.D., Ronald D. Rotunda, Marcia Rotunda, General Synergy Investments, Gabriel Fernandez, J. Mahar, CMF Associates, Alfred J. Hendron, Jr. and M.T. Davisson, respectfully pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Seventh Circuit, entered in this proceeding on January 9, 1990.

OPINIONS BELOW

The opinion of the Court of Appeals for the Seventh Circuit is reported at 892 F.2d 680 and is reprinted in the appendix hereto.

The opinions of the United States District Court for the Northern District of Illinois are reported at 681 F. Supp. 530 and 699 F. Supp. 161 and are also reprinted in the appendix hereto.

JURISDICTION

The judgment of the Court of Appeals for the Seventh Circuit was entered on January 9, 1990. This Petition for Certiorari was filed within ninety (90) days of that date. This Court's jurisdiction is invoked under 28 U.S.C. §1254(1).

STATUTORY PROVISIONS AND REGULATIONS INVOLVED

Section 10(b) of the Securities and Exchange Act of 1934, 15 U.S.C. §78(j)(b):

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange—
>
> * * *

(b) To use or employ, in connection with the purchase and sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the production of investors.

Section 1964(c) of the Racketeer Influenced and Corrupt Organizations Acts, 18 U.S.C. §1964(c):

Any person injured in his business or property by reason of a violation of section 1962 of this chapter may sue therefor in any appropriate United States district court and shall recover threefold the damages he sustains and the cost of the suit, including a reasonable attorney's fee.

Securities and Exchange Commission Rule 10b-5, 17 C.F.R. §240.10b-5:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any scheme, device or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of circumstances in which they were made, not misleading, or

(c) To engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

STATEMENT OF THE CASE

Petitioners were investors in oil and gas drilling limited partnerships which were promoted by respondents Petren Resources Corporation, Faestel Investment, Inc. and David J. Faestel. Petitioners' investments in the partnerships were solicited by means of written offering memoranda prepared by a law firm representing the partnerships, respondent McDermott, Will & Emery.

The offering memoranda prepared and circulated by respondents were false and misleading in that they failed to disclose material information about the qualifications and experience of the promoters and, in some instances, flatly misrepresented facts about their net worth. Petitioners relied upon the accuracy of the statements made in the offering memorandum in making their investment decisions and were induced by the respondents' false statements to both purchase and hold their partnership interests. Petitioners were unaware of the respondents' fraud and by the time they discovered it, their investments were totally worthless.

Subsequent to the discovery of the fraud, petitioners filed suit in the United States District Court of the Northern District of Illinois seeking to rescind the transactions and recover the full amount paid for their investments. Petitioners alleged claims for violations of §10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. §78(j)(b), and Securities and Exchange Commission Rule 10b-5, 17 C.F.R. §240.10b-5, and for violations of §1962 of the Racketeer Influenced and Corrupt Organizations Act ("RICO"), 18 U.S.C. §1962. Jurisdiction of the district court was invoked under 28 U.S.C. §1331; 15 U.S.C. §78aa; and under 18 U.S.C. §1964.

Respondents never answered petitioners' complaint. Instead they moved to dismiss it pursuant to Fed. R. Civ. P. 12(b)(6). Conceding that petitioners had alleged a series of actionable violations of the federal securities laws, respondents contended petitioners were, nevertheless, not entitled to recover because they had failed to allege facts showing "loss causation," *i.e.*, that the defendants' fraudulent conduct actually caused a subsequent decline in their investment. The district court agreed with respondents' contentions and dismissed petitioners' complaint.

In the district court's initial memorandum opinion, entered March 7, 1987, the court held that "loss causation" was an essential element of an implied private right of action under §10(b) and Rule 10b-5. In order to satisfy the "loss causation" requirement, petitioners were required to plead and prove "that the information defendants allegedly omitted from the offering memoranda caused the decline in their . . . partnership interests". (App. 23).[1]

The district court also dismissed petitioners' RICO claim, but not due to a failure to allege "loss causation." Instead the court said that "loss causation" was a "judicially-imposed limitation" on the implied right of action under the securities laws "which simply did not apply to statutorily created RICO claims." (App. 26)[2]

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[1] The district court afforded petitioners the opportunity to amend their §10b and Rule 10b-5 claims to conform to the loss causation requirements, but the court warned that any such amendments which later proved to be incorrect "might be subject to sanctions." (App. 23)

[2] The district court dismissed petitioners' RICO claim because of a technical pleading deficiency relating to their "enterprise" allegations. (App. 28) Plaintiffs were given leave to file an amended complaint to cure this pleading defect.

Petitioners filed an amended complaint and corrected their RICO claim. However, because, as passive limited partner investors, petitioners had not had access to information which showed exactly what "caused the subsequent decline in their investment," they elected to forego, at least temporarily, further pursuit of their §10b and Rule 10b-5 claims, thus avoiding the district court's threat of sanctions.[3]

Respondents moved to dismiss petitioner's amended complaint pursuant to Fed. R. Civ. 12(b)(6), reasserting the "loss causation" arguments. While these motions were pending, they also successfully resisted petitioners' discovery efforts, convincing the district court that, pending a ruling, discovery should be restricted.

On October 28, 1988, the district court issued its second memorandum opinion in the case and dismissed petitioners' amended complaint. (App. 29) The court ruled that to recover under RICO a plaintiff must plead common-law "proximate causation" and that, in this case, where the predicate acts for the RICO violation involved repeated instances of securities fraud, proximate cause requires "an allegation that [the alleged] *omissions* lead to a decline in the value of the plaintiffs' investments." (App. 36) (emphasis in original). In other words, the court, contrary to its earlier decision, held that to prevail under RICO, petitioners had to also allege and prove "loss causation."

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[3] Plaintiffs had hoped that once they filed their amended complaint they would be permitted to engage in full-scale discovery which would have allowed them to determine precisely what happened to their investments but, as will be seen, this was not the case.

The Court of Appeals for the Seventh Circuit affirmed both rulings by the district court. (App. 1) Recognizing that "there is no controlling precedent in the Supreme Court or in this Circuit" and that "there are cases on both sides of the question in other circuits," the Seventh Circuit nevertheless elected to fully embrace "loss causation" as an essential pleading requirement applicable in all civil RICO and §10b and Rule 10b-5 cases. Characterizing "loss causation" as "the standard rule of tort law" (App. 7), the court justified its decision by suggesting that without the imposition of restrictive causation requirements, defrauded investors would be able to recover "windfalls," while defendants would become the "insurers" of unforseen calamities, subject to unlimited liability.

Applying the "loss causation" principles to the facts of this case, the Seventh Circuit said that petitioners should not recover because, even if the respondents "had come clean in their offering memoranda" and disclosed the truth about their experience and capabilities, petitioners would have invested in other similar oil and gas ventures which would have also failed as a result of the "collapse of oil prices in the early 1980's". Specifically the court said:

> Defrauders are a bad lot and should be punished, but Rule 10b-5 does not make them insurers against national calamities. If the defendants' oil and gas ventures failed not because of the personal shortcomings that the defendants concealed but because of industry-wide phenomena that destroyed all or most such ventures, then the plaintiffs, given their demonstrated desire to invest in such ventures, lost nothing by reason of the defendants' fraud and have no claim to damages.

(App. 7) The court thus concluded that "[I]f the plaintiffs would have lost their investment regardless of the fraud, any award of damages to them would be a windfall." (App. 6)[4]

REASONS FOR GRANTING THE WRIT

1.

THE DECISION BELOW RAISES IMPORTANT QUESTIONS UNDER THE FEDERAL SECURITIES LAWS AND RICO WHICH HAVE NOT BEEN, BUT SHOULD BE, FINALLY SETTLED BY THIS COURT.

"Loss causation" has only recently been recognized by some courts as a separate element of a claim under §10b and Rule 10b-5. This case represents the first instance where a court of appeals has extended the "loss causa-

[4] Obviously, there is nothing in record to support the contention that if petitioners had been made aware of defendants' fraud they nevertheless would have readily invested in other oil and gas ventures. Moreover, the Seventh Circuit's suggestion that oil prices "collapsed" in the early 1980's and that this "caused" petitioners' loss is patently incorrect. Oil prices peaked in 1981 at $31.77 a barrel and gradually declined to $24.09 a barrel in 1985. The "collapse" in oil prices did not occur until 1986 when the price of oil dropped almost 50% to $12.50 a barrel. *See*, U.S. Dept. of Commerce, Bureau of the Census, Statistical Abstract of the United States, 1989 at 677 (Tab. 1181). (App. 5) Petitioners discovered that they had been defrauded and that their investments were worthless in 1984, well before the "collapse" in oil prices and while drilling for oil was still a profitable venture. It was petitioners' dissatisfaction with the performance of their investments and their inability to obtain information from the respondents concerning the status of their investments which ultimately led to the discovery of the fraud.

tion" requirement to claims under RICO. This Court has never considered the propriety of "loss causation" in either context.

Imposing a strict "loss causation" pleading requirement will necessarily restrict the ability of injured parties to recover under §10b and RICO because it is often difficult for investors to make a pre-filing determination concerning the actual cause of the decline in the value of their investments. Many defrauded investors, like petitioners here, may be foreclosed from §10b and RICO remedies simply because they cannot allege, with the certainty required by Fed. R. Civ. P. 11, that the defendant's fraud directly caused their loss. This Court historically has not countenanced pleading or procedural barriers which restrict the remedies available under §10b or RICO. For this reason, this Court, in the exercise of its judicial discretion, should carefully consider the decision of the Seventh Circuit and issue a writ of certiorari to review and settle, once and for all, the causation questions the decision raises.

Loss Causation is only a recent addition to the legal lexicon. The concept of "loss causation" had its origin in the Second Circuit's opinion in *Schlick v. Penn-Dixie Cement Corporation*, 507 F.2d 374 (2d Cir. 1974) *cert. denied*, 421 U.S. 976 (1975). There the court said that where a 10b-5 claim is predicated solely upon material omissions or misstatements in proxy materials "there would have to be a showing of both *loss causation*—that the misrepresentations or omissions caused the economic harm—and *transaction causation*—that the violations in question caused the appellant to engage in the transaction in question." *Id.* at 38 (emphasis in original) The Second Circuit did not explain why it was necessary to show both "loss causation" and "transaction causation," saying only that

loss causation "is demonstrated rather easily by proof of some form of economic damage." *Id.*

The subject of "loss causation" remained dormant for six years until 1980, when the Second Circuit again visited the subject in *Marbury Management, Inc. v. Kohn*, 629 F.2d 705 (2d Cir.), *cert. denied*, 449 U.S. 1011 (1980). In *Marbury*, the court specifically rejected the notion that a defrauded investor had to plead and prove "loss causation" in order to recover under §10b. The court instead held that where an investor had been induced by fraud to invest, he would be entitled to recover his full loss regardless of whether the loss was attributable to the defendant's fraud.

There was a strong dissent filed in *Marbury*, however, which argued in favor of a strict application of a "loss causation" requirement. The *Marbury* majority responded to the dissent by warning that the adoption of any "new rule effectively limiting recovery for fraudulently induced securities transactions to instances of fraudulent representations about the value characteristics of the securities dealt in . . . would be too accommodative of many common types of fraud, such as the misrepresentation of a collateral fact that induces a transaction." *Id.* at 710, fn. 3.

Unfortunately, the *Marbury* dissent has gained greater favor in subsequent years and now, as a result, many courts, like the court below, deny recovery for fraudulently induced securities transactions where the fraud is not directly linked to a subsequent decline in the value of the underlying security. *See e.g., Huddleston v. Hermann & MacLean*, 640 F. 2d 534, 549-50, (5th Cir. 1981), *aff'd. in part on other grounds and rev'd. in part on other grounds*, 459 U.S. 375 (1983); *Bennett v. United States Trust Co.*,

770 F.2d 308, 313-14 (2d Cir. 1985); and *Currie v. Cayman Resources Corp.*, 835 F.2d 780, 785 (11th Cir. 1989).[5]

None of the courts which have adopted the "loss causation" requirement have considered, to any extent, whether the concept finds support in the language of the securities laws or the policies which underlie them. Instead, the majority of the courts, including the court below, have simply looked to common law tort concepts of causation and attempted to adapt them in the federal securities law context.

Efforts to shape the contours of the implied right of action under §10(b) with common law principles have often been criticized by this Court. *See, e.g., SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963) (holding that common-law doctrines of fraud which developed around transactions involving tangible items of wealth are ill-suited to the sale of intangibles such as securities.) In fact, this Court specifically criticized the Fifth Circuit's *Huddleston* decision for attempting to apply common law principles when analyzing the appropriate standard of proof in §10(b) actions:

> "[T]he typical fact situation in which the classic tort of misrepresentation and deceit evolved was light years away from the world of commercial transactions to which Rule 10b-5 is applicable". Moreover, the anti-fraud provisions of the securities laws are not coextensive with common law doctrines of fraud. Indeed, an important purpose of the federal securities statutes was to rectify perceived deficiencies in the available common law protections by establishing

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[5] The Fifth Circuit's 1981 decision in *Huddleston* was the first court of appeals decision subsequent to *Schlick* to recognize the "loss causation" requirement.

> higher standards of conduct in the securities industry. *See, SEC v. Capital Gains Research Bureau, Inc., supra*, 375 U.S., at 186, 84 S.Ct., at 279.

Id. at 308.

More recently, in *Randall v. Loftsgaarden*, 478 U.S. 647 (1986), the Court re-emphasized that Congress' aim in the 1934 Act was "not confined solely to compensating defrauded investors," but that Congress also "intended to deter fraud." *Id.* at 644. The Court recognized that this deterrent purpose would be "ill-served by too rigid insistence on limiting plaintiffs to recovery of their 'net economic loss'." *Id.* Indeed, *Randall* acknowledged, in *dictum*, that imposing liability on defendants for all losses caused by fraud would only serve to advance §10b's deterrent intent. *Id.* at 661.

Despite this Court's guidance, the courts of appeals which have adopted the "loss causation" requirement have done so without any real analysis of whether application of a strict causation requirement would further Congress' intent. Instead, these courts have mechanically applied common law tort principles, ignoring the fact that the implied action under §10b was intended to supplant and expand common law remedies.

Imposing strict causation requirements only serves to compromise the deterrent purpose of the securities laws, allowing some defendants to escape liability altogether because the defrauded plaintiffs cannot satisfy the causation test. For example, in the Fifth Circuit's decision in *Huddleston*, the plaintiffs proved without doubt that the defendants used false and misleading financial statements to induce them to purchase securities. Yet, the Fifth Circuit said that the plaintiffs would not be entitled to recover if the defendants could show that the failure of the in-

vestment was due to other causes, such as "bad weather." Here there is no question respondents used a false and misleading offering memorandum to solicit the petitioners, yet the petitioners have been denied the opportunity to obtain any recovery because they did not have sufficient facts available to them to allege with the certainty required by Fed. R. Civ. P. 11 that the respondents fraudulent conduct directly caused a subsequent decline in the value of their investments.[6]

It is not surprising that in the wake of *Huddleston* and its progeny, "loss causation" has become the darling of securities fraud defendants. What the loss causation decisions tells these defendants is that even though they have committed fraud, they have a good chance of escaping or limiting their liability by persuading a judge or jury that there was, or reasonably could be, another "cause" for the decline in the value of the investment.

For example, under the loss causation analysis, any defendant who fraudulently induced investors to purchase publicly traded stock shortly before the stock market crashes of 1929, 1987 or 1989, should be able to easily avoid liability by claiming that the investors' losses were not caused by their fraud, but resulted from the market collapse. Similarly, under the Seventh Circuit's analysis, all investors who were fraudulently induced to invest in oil and gas ventures in the early 1980's would be precluded from any recovery because it can be assumed that

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[6] In its opinion, the Seventh Circuit suggested that petitioners could have satisfied Rule 11 by determining that other oil and gas ventures managed by competent and honest personnel profited while petitioners' venture failed. But the court fails to explain how proof of the success of other ventures establishes why petitioners' venture failed.

they would have invested in oil and gas even absent any fraud and thus would have lost their investment anyway when the price of oil collapsed.

"Loss causation" not only limits an investor's ability to recover and enhances defendant's chances of escaping liability, it also undercuts the policy of full disclosure which underpins the securities laws. *Basic, Inc. v. Levinson*, 485 U.S. 224, 246 (1988). For example, in cases like this, there would be little motivation for a promoter to be candid about collateral but material matters not directly related to the value of the security because he knows that an investor could have a difficult time alleging and proving that the concealed collateral facts directly caused a subsequent decline in the security's value. Because loss causation significantly reduces a defendant's potential exposure to liability, upholding the causation requirement is likely to encourage rather than discourage the withholding of material adverse facts.

The courts which have embraced "loss causation" have not only ignored the negative impact the causation requirement will have on the important policy considerations underlying §10b and Rule 10b-5, they have also not considered relevant decisions by this Court which directly address the causation question. For example, in *Mills v. Electric Auto-Lite*, 396 U.S. 375 (1970), the Court was asked to decide whether an implied cause of action for violations of §14(a) of the 1934 Act (relating to fraudulent or misleading proxy solicitations) could be sustained without a showing of a direct causal link between the defect in the proxy statement and the outcome of the voting. The Court analyzed the question in terms of materiality and concluded that where the misstatement or omission in the proxy statement was shown to be material,

a shareholder has made a sufficient showing of causal relationship between the violation and the injury for which he seeks redress. The Court specifically rejected the notion that in order to prevail, an aggrieved shareholder also had to allege and prove a direct causal link between the misstatement or omission and the outcome of the vote. *Id.* at 385-87.

A similar test of causation was adopted by the Court in the context of implied actions under §10(b). In *Affiliated Ute v. United States*, 406 U.S. 128, 152 (1972), the Court held that in an omissions case brought under §10(b) causation in fact was established by showing that a material fact which may have impacted an investment decision was intentionally withheld by a person having a duty to disclose. The Court imposed no separate requirement that the withheld fact also "cause" a subsequent decline in the investment. The Court simply held that where the withholding of a material fact is shown an investor is entitled to recover.

The amount a defrauded investor should recover raises a separate question. In *Mills*, this Court interpreted §29(b) of the Exchange Act as rendering any contract made in violation of the Act or any rule thereunder voidable and subject to rescission at the option of the innocent party. *Id.* at 387-88.[7] Similarly, in *Randall*, the Court recognized, without explicitly deciding, that rescission or a rescissory

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[7] Section 29(b), 15 U.S.C. §78cc(b), provides in pertinent part:

> Every contract made in violation of any provision of this chapter or of any rule or regulation thereunder . . . shall be void (1) as regards the rights of any person who, in violation of any such provision, rule, or regulation, shall have made . . . any such contract. . .

measure of damages may sometimes be appropriate under §10b. *Id.* 478 U.S. at 662.[8]

Assuming, arguendo, that rescission is an available remedy for violations of §10b or Rule 10b-5, the question of "loss causation" becomes totally irrelevant because the victim of the fraud is able to obtain full restitution of the purchase price upon tender of the security. This is true regardless of whether there has been any decline in the value of the security caused by the defendant's fraud. *Randall*, 478 U.S. at 659.

Even assuming rescission is not available as a remedy, defrauded investors need not establish "loss causation" in order to recover. In *Affiliated Ute*, this Court recognized that a defrauded investor may recover damages where the defendant realizes a profit that exceeds any actual loss the investor sustained. *Id.* 406 U.S. at 156. As this Court explained in *Randall*, requiring securities fraud defendants to disgorge ill-gotten profits adds an additional measure of deterrence:

> This alternative standard aims at preventing the unjust enrichment of a fraudulent buyer, and it clearly does more than simply make the plaintiff whole for the economic loss proximately caused by the buyer's fraud. Indeed, the accepted rationale underlying this alternative is simply that "[i]t is more appropriate to give the defrauded party the benefit even of windfalls than to let the fraudulent party keep them." *Janigan v. Taylor*, 344 F.2d 781, 786 (CA1) *cert. denied*, 382 U.S. 879, 15 L. Ed. 2d 120, 86 S.Ct. 163

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[8] Even under common law principles, a party who is fraudulently induced to enter into a transaction has the right to rescind the transaction and recover his full consideration. *See*, Restatement (Second) of Restitution §28 (1977); Restatement (Second) of Contracts §164 (1979).

(1965). See also *Falk v. Hoffman*, 233 N.Y. 199, 135 N.E. 243 (1922).

478 U.S. at 663.

Finally, even under a stricter compensatory measure of damage, a defrauded investor is at least entitled to recover "the difference between the fair value of all the [investor] received and the fair value of what he would have received had there been no fraudulent conduct." *Affiliated Ute*, 406 U.S. at 156. In this case, there is no question that petitioners did not receive the investment they bargained for.

Petitioners were told they were investing in an oil and gas venture being managed by able and experienced industry experts. In fact, the promoters were incompetent, inexperienced, had been sued in connection with prior ventures and were on the verge of financial collapse. There can be little doubt that an oil and gas venture which is being managed by incompetents does not have the same value to an investor as one being managed by an experienced and capable staff. The risks involved in poorly managed venture far exceed the risks involved in a well managed one. To suggest under the circumstances of this case, where petitioners were induced by fraud to commit their capital to a venture that involved greater risk than had been represented, they suffered no compensable loss, simply ignores the realities of the transaction.

Under the "loss causation" analysis adopted by the Seventh Circuit defrauded investors are not only precluded from recovering the kind of compensatory damages contemplated in *Affiliated Ute*, they are also not allowed to obtain rescission or rescissory damages, or to seek disgorgement of the defendant's profits. Instead, the investors' recovery is strictly limited to an amount meas-

ured by any decline in the value of the security directly caused by the defendant's fraud. If the investor cannot allege and prove such specific injury, there is no recovery and the defendant is absolved of any liability and allowed to retain all the benefits derived from the fraud.

The justification for this kind of a result apparently arises out of a concern for imposing unwarranted liability on fraud defendants. As the dissent put it in *Marbury*, the concern is that without a strict loss causation requirement the perpetrator of the securities fraud would "become an insurer of the investment, responsible for an indefinite period of time for any and all manner of unforeseen difficulties which may eventually beset the stock." *Id.* 629 F.2d at 718. This same sentiment was expressed by the Fifth Circuit in *Huddleston*, 640 F.2d at 549, and it was expressed by the Seventh Circuit and the district court in this case. (App. 7, 23)

But in expressing their concern for the protection of securities fraud defendants, these courts overlook two important facts. First, the defendant only becomes the "insurer" of the investment if it can be shown that, in connection with the purchase or sale of the security, he acted with scienter, *i.e.*, a specific intent to defraud. It is unclear why anyone should be concerned about protecting the rights and liabilities of persons who have been proven to have engaged in intentional fraud. Second, the securities fraud defendant can easily avoid becoming an "insurer" of an investment by complying with the disclosure requirements of the securities laws. When the defendant knowingly elects to ignore those requirements and proceeds to fraudulently induce innocent parties to invest, there is no good reason why he should not be compelled to "insure" the victims of his acts.

That is not to say that in all cases a defendants' liability is unlimited. A defendant should not be compelled to bear the consequences of a risk which the investor would otherwise have accepted. Thus, in this case, if the defendants can show that the petitioners would have assumed the risk of the venture, even if the truth about their qualifications and experience were known, then there would be no recovery. Similarly, a defendant should not be held responsible for any loss which occurs after the fraudulent conduct is disclosed. But while an investor remains the unwitting victim of the defendants' fraud, any loss that the investor sustains should be the responsibility of the defendant. To permit otherwise would defeat and not effectuate, the purpose of the securities laws and encourage, not deter, securities fraud.

The same rationale applies under RICO. In affirming the dismissal of petitioners' civil RICO claim, the Seventh Circuit applied the principles of "loss causation" calling it "just an exotic name for a standard requirement of tort law." (App. 7) But imposition of this "standard requirement of tort law" is inconsistent both with this Court's decisions under RICO and the deterrent policies the Act was intended to implement.

The express civil remedy set forth in RICO does not require that a party seeking relief plead "loss causation" or "proximate causation." All RICO requires is that the party be injured in his business or property "by reason of" a RICO violation.[9] Whether this language requires

[9] Specifically, Section 1964(c), 18 U.S.C. §1964(c), provides:

> Any person injured in his business or property by reason of a violation of section 1962 of this chapter may sue therefor in any appropriate United States district court and shall recover threefold the damages he sustains and the cost of the suit, including a reasonable attorney's fee.

"loss causation" or "proximate cause" or some lesser causal connection is a matter of statutory construction.

This Court has said that in identifying the limits of an explicit statutory remedy, legislative intent is the controlling consideration. *Blue Shield of Virginia v. McCready*, 467 U.S. 465, 477 n. 13 (1982), citing *Merrill Lynch, Pierce, Fenner & Smith v. Curran*, 456 U.S. 353, 377-78 (1982). While Congress never directed its attention specifically to RICO's "by reason of language," much has been written about the legislative intent.[10] Most significant is the often cited admonition that RICO is to "be liberally construed to effectuate its remedial purposes." Pub. L. 91-452, §904(a), 84 Stat. 947.

In *Sedima, S.P.R.L. v. Imrex Co.*, 473 U.S. 479, 498 (1985), this Court said that RICO's " 'remedial purposes' are nowhere more evident than in the provision of a private action for those injured by racketeering activity." The Court cautioned that narrow interpretations of the private remedy would only serve to defeat the Act's remedial intent. *Id.* The Court supported its conclusion by pointing out that a previous proposal to simply add RICO-like provisions to the Sherman Act was rejected precisely because it "could create inappropriate and unnecessary obstacles in the way of . . . a private litigant [who] would have to contend with a body of precedent—appropriate in a purely antitrust context—setting strict requirements on questions such as 'standing to sue' and 'proximate cause'." 115 Cong. Rec. 6995 (1969) (ABA comments on S. 2048).

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[10] *See* Organized Crime Control Act of 1970, H.Rep. No. 91-1549, 91st Cong., 2d Sess. (Sept. 30, 1970); 116 Cong. Rec. 35191-217 (Oct. 6, 1970); *Id.* at 35287-364 (Oct. 7, 1970); *Id.* at 36281-96 (Oct. 12, 1970); *Id.* at 35201; *Id.* at 35196-97, 35200; *Id.* at 36294, 36296.

In this case, by imposing a strict "proximate cause" or "loss causation" requirement on private remedies under RICO, the Seventh Circuit created the exact problem Congress sought to avoid. The court limited the private remedy using common law principles inappropriate in this context. The Act requires only that there be an injury "by reason of" a RICO violation. This requirement should be broadly construed to effectuate the Act's remedial purpose.

2.

THERE IS CONFUSION AND CONFLICT BETWEEN AND WITHIN THE CIRCUITS REGARDING LOSS CAUSATION.

Both the Seventh Circuit and district court recognized in their decisions below that there is confusion and conflicts concerning the causation requirement in §10b and Rule 10b-5 actions. (App. 8, 17-18) This confusion and conflict even exists within in the Seventh Circuit.

In an earlier decision, the Seventh Circuit, in *dictum*, expressly criticized the "loss causation/transaction causation" analysis stating, "[T]hese terms, ungainly to start with because they constrict nouns for service as adjectives, have been confusing in practice because they do not link the definition of 'causation' to any theory about why people might be liable under the securities laws." *LHLC Corp. v. Cluett Peabody & Co.*, 842 F.2d 928, 931 (7th Cir.), *cert. denied*, 109 S.Ct. 311 (1988). The Court explained that when analyzing causation under the securities laws the focus should be on "whether the information disclosed or withheld affected an investment decision." *Id.*

Subsequently, in *Rankow v. First Chicago Corporation*, 870 F.2d 356 (7th Cir. 1989), the Seventh Circuit seemingly rejected the very same loss causation theory adopted by the court in this case. In *Rankow*, the Seventh Circuit held:

> The theory of loss causation advanced by [the defendant] and accepted by the district court is a good example of this confusion. Under the district court's theory, any intervening change in market conditions not directly caused by the defendant could break the chain of causation and exempt the defendant from liability, a result that would eviscerate Rule 10b-5.

Id. at 367. Although the court in *Rankow* did not totally abandon the loss causation analysis, it did hold that under its view of the loss causation, the loss causation requirement could be met "rather easily by proof of some form of economic damage." *Id. citing Schlick*, 507 F.2d at 380.

The Second Circuit has also issued a number of seemingly conflicting opinions which have only added to the confusion concerning loss causation. Compare *Manufacturers Hanover Trust Company v. Drysdale Securities Corporation*, 801 F.2d 13 (2nd Cir. 1986), *cert. denied*, 107 S.Ct. 952 (1987) (reaffirming the *Marbury* majority analysis) with *Bennett v. United States Trust Co. of New York*, 770 F.2d 308, 313 (2nd Cir. 1986), *cert. denied*, 106 S.Ct. 800 (1987) (requiring a strict showing of both "loss causation" and "transaction causation").

The Fifth Circuit too has undercut a strict application of the loss causation requirement where, as in this case, it is alleged that absent the defendants' fraud, the securities would have been unmarketable. *Shores v. Sklar*, 647 F.2d 462, 470 (5th Cir. 1981) (en banc), *cert. denied*, 459 U.S. 1102 (1983).

Other courts, apparently trying to reconcile *Huddleston* with the majority opinion in *Marbury*, have created exceptions to the loss causation requirement where brokers, privities or fiduciaries are involved. *See, e.g.*, *Hatrock v. Edward D. Jones & Co.*, 750 F.2d 767, 773 (9th Cir. 1984); *In re Letterman Bros. Energy Securities Litigation*, 799

F.2d 967, 972 (5th Cir. 1986), *cert. denied*, 197 S.Ct. 1373 (1987).

Finally, the Eleventh Circuit recently recognized an exception to a strict application of the "loss causation" requirement "when a defendant misrepresents a stock's intrinsic worth at the time of the representation." *Bruschi v. Brown*, 876 F.2d 1526, 1531 (11th Cir. 1989)

Causation is no doubt a troublesome concept and the lower courts have had difficulty grappling with its application in the §10b and RICO contexts. What has evolved is a series of conflicting and inconsistent decisions which have caused confusion and concern for the courts and investors alike. Because of the confusion, there is a compelling need for this Court, at this juncture, to examine the causation question and provide the lower courts with some direction. This case affords the Court the opportunity to do just that.

CONCLUSION

For these reasons, a writ of certiorari should issue to review the judgment and opinion of the Seventh Circuit.

Respectfully submitted,

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APPENDICES

APPENDIX 1

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892 F.2d 680 (1990)

IN THE
UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

No. 88-3299

R. RICHARD BASTIAN, III, *et al.*,

Plaintiffs-Appellants,

v.

PETREN RESOURCES CORPORATION, *et al.*,

Defendants-Appellees.

Appeal from the United States District Court
for the Northern District of Illinois, Eastern Division.
No. 86 C 2006—**Brian Barnett Duff**, *Judge.*

ARGUED OCTOBER 25, 1989—DECIDED JANUARY 9, 1990

Before BAUER, *Chief Judge*, POSNER, *Circuit Judge*, and ESCHBACH, *Senior Circuit Judge.*

POSNER, *Circuit Judge.* In 1981 the plaintiffs invested $600,000 in oil and gas limited partnerships promoted by the defendants. The plaintiffs allege that, had it not been for the offering memoranda's misrepresentations and misleading omissions concerning the defendants' competence and integrity, the plaintiffs would not have invested in these partnerships, which by 1984 were worthless. The original complaint charged violations of Rule 10b-5 of the

Securities and Exchange Commission, and the RICO statute (18 U.S.C. §§ 1961 *et seq.*), and sought damages equal to the investment. The district judge dismissed this complaint, but without prejudice, on the defendants' motion under Fed. R. Civ. P. 12(b)(6) to dismiss for failure to state a claim. 681 F. Supp. 539 (N.D. Ill. 1988). With respect to the RICO charge he found only a minor technical deficiency easily curable by filing an amended complaint. With respect to the Rule 10b-5 charge he found a more serious deficiency: a failure to allege "loss causation"—that is, that if the facts had been as represented by the defendants the value of the limited partnerships would not have declined. This deficiency, too, was potentially curable by an amendment to the complaint, but the judge warned the plaintiffs that if they alleged but later failed to prove loss causation he might impose sanctions on them under Fed. R. Civ. P. 11.

The plaintiffs filed an amended complaint, curing the RICO oversight, but they did not reallege a violation of Rule 10b-5. The district judge dismissed the amended complaint on the ground that proximate cause in a RICO case requires, much as in a Rule 10b-5 case, that the facts concealed or distorted were responsible for the decline in the value of the limited partnerships. The amended complaint contained no such allegation, no doubt for the same reason the plaintiffs had not amended their Rule 10b-5 count: they did not think they could prove loss causation. The dismissal this time was with prejudice, and so terminated the suit and set the stage for this appeal.

The defendants argue that having failed to include the Rule 10b-5 charge in the amended complaint, the plaintiffs have waived any challenge to the district judge's dismissal of that charge in the original complaint. We disagree. That dismissal was not an appealable order, because the dismissal of a complaint with leave to amend is not a final decision. *Harris v. Milwaukee County Circuit Court*, 886 F.2d 982, 984 (7th Cir. 1989); 28 U.S.C. § 1291. There was no appealable order until Judge Duff dismissed the amended complaint with prejudice. When a final decision is appealed, the appeal brings up all previous

rulings of the district judge adverse to the appellant. *Asset Allocation & Management Co. v. Western Employers Ins. Co.*, No. 89-1686, slip op. at 3 (7th Cir. Dec. 26, 1989); *Disher v. Information Resources, Inc.*, 873 F.2d 136, 140-41 (7th Cir. 1989). Otherwise there would be no way to obtain appellate review of those rulings, save for the exceptional few that were appealable regardless of finality.

It is not waiver—it is prudence and economy—for parties not to reassert a position that the trial judge has rejected. Had the plaintiffs repleaded their Rule 10b-5 charge without alleging loss causation, the judge would have dismissed the charge, not only with prejudice but with annoyance. If they had alleged loss causation, they would have abandoned their principal disagreement with Judge Duff, which is over whether such an allegation is necessary, and would indeed have exposed themselves to sanctions if, as we suspect, they have no evidence of loss causation. For if they had had sufficient evidence to satisfy Rule 11's requirement of a reasonable precomplaint inquiry, they would have amended their complaint, while reserving for appeal (should they lose in the district court) their contention that proof of loss causation is inessential.

The case is no different from one in which a district judge grants partial summary judgment for the defendant, dismissing one of the plaintiff's claims, and after a trial dismisses the rest of the claims. Except as permitted by Fed. R. Civ. P. 54(b), the plaintiff cannot appeal until all his claims have been dismissed, but when he does appeal he can bring up the grant of partial summary judgment. He need not request the district court to reexamine its earlier rulings.

We come to the merits. The plaintiffs argue that they should not be required to allege that, but for the circumstances that the fraud concealed, the investment that they were induced by the fraud to make would not have lost its value. They say it should be enough to allege that they would not have invested but for the fraud; for if they had not invested, they would not have lost their money, and the fraud was therefore the cause of their loss. They say

they have no idea why their investment was wiped out and it does not matter; the defendants, being responsible for the disaster by having used fraud to induce the investment, must not be allowed to get off scot-free just because the plaintiffs do not know how the investment would have fared in the marketplace had the facts about the defendants' competence and integrity been as represented. As a fallback position the plaintiffs argue that the defendants should have the burden of proving what part (if any) of the loss would have occurred even if the defendants had been as competent and honest as represented.

Rule 10b-5 is not a complete scheme for remedying securities fraud. Indeed, it is just a declaration that securities fraud is unlawful. The right to bring a private action for damages that the rule has been held to confer is an implied right, *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6, 13 n. 9 (1971), and its dimensions and incidents are a common law growth nourished by analogies from the law of torts. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 744-49 (1975); *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90, 97 (10th Cir. 1971); *Brennan v. Midwestern United Life Ins. Co.*, 259 F. Supp. 673, 680 (N.D. Ind. 1966) (Eschbach, J.); cf. *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 192-95 (1963). All Rule 10b-5 does is supply the foundation upon which federal judges have built a federal common law of securities fraud. *Starkman v. Marathon Oil Co.*, 772 F.2d 231, 238 (6th Cir. 1985). It would be surprising therefore if the rules that have evolved over many years to establish the contours of common law actions for fraud and other intentional torts were entirely inapplicable to suits under Rule 10b-5, and of course they are not. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

Indeed what securities lawyers call "loss causation" *is* the standard common law fraud rule (on which see Prosser and Keeton on the Law of Torts § 110, at p. 767 (5th ed. 1984)), merely borrowed for use in federal securities fraud cases. It is more fundamental still; it is an instance

of the common law's universal requirement that the tort plaintiff prove causation. *Cenco Inc. v. Seidman & Seidman*, 686 F.2d 449, 453 (7th Cir. 1982). No hurt, no tort. *Heil v. Morrison Knudsen Corp.*, 863 F.2d 546, 550 (7th Cir. 1988). Forget fraud for a moment and consider a standard medical malpractice case. The plaintiff's decedent goes to the defendant for medical treatment, receives incompetent treatment, dies. The plaintiff must allege that, had it not been for the incompetent treatment, his decedent would have lived (or lived longer). It is no answer that the plaintiff cannot be expected to know *why* his decedent died; it is his burden to gather enough information on the matter in advance of filing suit to comply (if the suit is in federal court) with Rule 11's requirement of a reasonable precomplaint inquiry. Even if the defendant in our hypothetical malpractice case had been a veterinarian passing himself off as a physician, the plaintiff would have to show that the defendant had failed to meet the standard of care of a physician. Prosser and Keeton on the Law of Torts, *supra*, § 36, at p. 226.

The plaintiffs alleged that they invested in the defendants' limited partnerships because of the defendants' misrepresentations, and that their investment was wiped out. But they suggest no reason *why* the investment was wiped out. They have alleged the cause of their entering into the transaction in which they lost money but not the cause of the transaction's turning out to be a losing one. It happens that 1981 was a peak year for oil prices and that those prices declined steady in the succeeding years. U.S. Dept. of Commerce, Bureau of the Census, Statistical Abstract of the United States, 1989, at 677 (tab. 1181). When this happened the profitability of drilling for oil (and gas, which generally is produced with it) in the continental United States plummeted. The costs of obtaining oil and gas from our depleted reservoirs are far higher than the costs in other regions, and drilling for oil and gas is therefore profitable only in times when prices are very high. Suppose that because of the unexpected drop in oil prices after 1981, all or the vast majority of the oil and

gas limited partnerships formed in 1981 became worthless. Then it would be highly unlikely that the plaintiffs' loss was due to the defendants' fraud. If the defendants had come clean in their offering memoranda, then we may assume—because the plaintiffs allege, and the case was dismissed on the complaint—that the plaintiffs would not have invested in the defendants' limited partnerships. But there were plenty of other oil and gas limited partnerships they could have invested in. They wanted to invest in oil and gas limited partnerships; they only wanted to be sure that the general partners were honest and competent people. Yet to be honest and competent is not to be gifted with prevision. If the alternative oil and gas limited partnerships to which these plaintiffs would have turned had the defendants leveled with them were also doomed, despite competent and honest management, to become worthless, the plaintiffs were not hurt by the fraud; it affected the place but not the time or amount of their loss.

To satisfy Rule 11 all that the plaintiffs had to do was to obtain evidence from persons knowledgeable about oil and gas ventures in the early 1980s that many or most oil and gas ventures had succeeded notwithstanding the downturn in price after 1981. Perhaps if the plaintiffs had conducted such a search they would have discovered, contrary to our speculation (and it is just that), that oil and gas ventures managed by competent and honest businessmen *had* survived the drop in oil prices. If so, this would support an inference that if the defendants had been as competent and honest as they represented themselves to be, they would not have lost the plaintiffs' $600,000. The plaintiffs' unwillingness to make this allegation in their amended complaint suggests to us that they may have made inquiry of experts in the oil and gas industry and discovered that the cause of the disaster was unrelated to the competence and honesty of the defendants.

If the plaintiffs would have lost their investment regardless of the fraud, any award of damages to them would be a windfall. Other sections of the securities laws, such as section 12(2) of the 1933 Act, 15 U.S.C. § 77*l*, permit

windfall recoveries, but we do not see how this helps the plaintiffs. Those sections deal with other conduct and some of them contain restrictions on liability that Rule 10b-5 does not. See, e.g., 15 U.S.C. § 77m; *Wilson v. Ruffa & Hanover, P.C.*, 844 F.2d 81, 84 (2d Cir. 1988). And proof of loss causation has been held to be required in some actions under section 12(2), *Wilson v. Ruffa & Hanover, P.C., supra*, 844 F.2d at 85-86, while in actions under section 11 of the 1933 Act, 15 U.S.C. § 77k, absence of loss causation is an explicit defense. Rule 10b-5 has been interpreted to authorize the creation of a federal common law of securities fraud, and common law fraud is not actionable without proof of harm. No reason is given why Rule 10b-5 should be an exception to this principle.

"Loss causation" is an exotic name—perhaps an unhappy one, *LHLC Corp. v. Cluett, Peabody & Co.*, 842 F.2d 928, 931 (7th Cir. 1988)—for the standard rule of tort law that the plaintiff must allege and prove that, but for the defendant's wrongdoing, the plaintiff would not have incurred the harm of which he complains. Like a stock-market crash, the collapse of oil prices in the early 1980s reverberated throughout the economy. Since the United States is a net importer of oil, the reverberations were for the most part good ones. But there were some losers. No social purpose would be served by encouraging everyone who suffers an investment loss because of an unanticipated change in market conditions to pick through offering memoranda with a fine-tooth comb in the hope of uncovering a misrepresentation. Defrauders are a bad lot and should be punished, but Rule 10b-5 does not make them insurers against national economic calamities. If the defendants' oil and gas ventures failed not because of the personal shortcomings that the defendants concealed but because of industry-wide phenomena that destroyed all or most such ventures, then the plaintiffs, given their demonstrated desire to invest in such ventures, lost nothing by reason of the defendants' fraud and have no claim to damages. *Sims v. Faestel*, 638 F. Supp. 1281 (E.D. Pa. 1986), aff'd without opinion, 813 F.2d 399 (3d Cir. 1987).

We have treated the question whether loss causation is an element of a claim for damages under Rule 10b-5 from the ground up because there is no controlling precedent in the Supreme Court or in this circuit, and because there are cases on both sides of the question in the other circuits, though they greatly preponderate in favor of the requirement and such conflict as there is appears to be within rather than among circuits. Compare *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 380-81 (2d Cir., 1974); *Huddleston v. Herman & MacLean*, 640 F.2d 534, 549-50 (5th Cir.), aff'd in part, rev'd in part on other grounds, 459 U.S. 375 (1983); *Bennett v. United States Trust Co.*, 770 F.2d 308, 313-14 (2d Cir. 1985), and *Currie v. Cayman Resources Corp.*, 835 F.2d 780, 785 (11th Cir. 1988), with *Marbury Management, Inc. v. Kohn*, 629 F.2d 705, 708-10 (2d Cir. 1980), and *Bruschi v. Brown*, 876 F.2d 1526, 1530-31 (11th Cir. 1989). Our cases either state in dictum, or assume, that the requirement does exist. *LHLC Corp. v. Cluett, Peabody & Corp., supra*, 842 F.2d at 931; *Kademian v. Ladish Co.*, 792 F.2d 614, 628 n. 11 (7th Cir. 1986); *First Interstate Bank v. Chapman & Cutler*, 837 F.2d 775, 779 (7th Cir. 1988); *Rankow v. First Chicago Corp.*, 870 F.2d 356, 367 (7th Cir. 1989). We have tried to explain why it should exist, and now we add a note on its scope which suggests that some of the cases that express disagreement with the doctrine may be reconcilable with it. Suppose a broker gives false assurances to his customer that an investment is risk-free. In fact it is risky, the risk materializes, the investment is lost. Here there can be no presumption that but for the misrepresentation the customer would have made an equally risky investment. On the contrary, the fact that the broker assured the customer that the investment was free of risk suggests that the customer was looking for a safe investment. Liability in such a case (well illustrated by *Bruschi v. Brown, supra*, 876 F.2d at 1527) is therefore consistent with nonliability in a case such as the present. The plaintiffs in the present case were not told that oil and gas partnerships are risk-free. They knew they were assuming a risk that oil prices might drop unexpectedly.

They are unwilling to try to prove that anything beyond the materializing of that risk caused their loss.

Because "loss causation" is just an exotic name for a standard requirement of tort law, Judge Duff was also correct to dismiss the amended complaint. Cf. *Currie v. Cayman Resources Corp., supra*, 835 F.2d at 785-86. The plaintiffs would not allege that the defendants' violations of the RICO statute caused the investment loss that the plaintiffs seek by this lawsuit to recoup. A civil RICO suit requires pleading and proof of loss "by reason of" the defendant's violation. 18 U.S.C. § 1964(c). This means cause. *Haroco v. American National Bank & Trust Co.*, 747 F.2d 384, 398 (7th Cir. 1984), aff'd per curiam, 473 U.S. 606 (1985); *Sperber v. Boesky*, 849 F.2d 60, 64 (2d Cir. 1988); *Brandenburg v. Seidel*, 859 F.2d 1179, 1187 (4th Cir. 1988). If the plaintiffs would have lost their shirts in the oil and gas business regardless of the defendants' violations of RICO, they have incurred no loss for which RICO provides a remedy.

The cases go further, by requiring not only cause but also "proximate cause." *Brandenburg v. Seidel, supra*, 859 F.2d at 1189; *Zervas v. Faulkner*, 861 F.2d 823, 834-35 (5th Cir. 1988). This unfortunate bit of legal jargon is used to cut off liability, for a variety of special reasons, for harms caused by the defendant's conduct in the ordinary-language sense of "caused." Cf. *Rardin v. T & D Machine Handling, Inc.*, No. 89-1271 (7th Cir. Nov. 21, 1989). We need not explore the nature of these grounds in the RICO setting, a subject canvassed in the *Zervas* and *Brandenburg* cases as well as in our own *Marshall & Ilsley Trust Co. v. Pate*, 819 F.2d 806 (7th Cir. 1987). Some cases describe the requirement of showing loss causation in Rule 10b-5 as an element of proximate cause (*Currie v. Cayman Resources Corp., supra*, 835 F.2d at 785, for example), but we think it more accurately described as an element of cause, period. For if it is not established, the trier of fact can have no confidence that the plaintiff would be better off if the defendant had refrained from the unlawful act.

AFFIRMED.

JUDGMENT – ORAL ARGUMENT

UNITED STATES COURT OF APPEALS
For the Seventh Circuit
Chicago, Illinois 60604

January 9, 1990.

Before

Hon. WILLIAM J. BAUER, *Chief Judge*
Hon. RICHARD A. POSNER, *Circuit Judge*
Hon. JESSE E. ESCHBACH, *Senior Circuit Judge*

R. RICHARD BASTIAN, III, et al.,

Plaintiffs-Appellants,

No. 88-3299 vs.

PETREN RESOURCES CORPORATION, et al.,

Defendants-Appellees.

Appeal from the United States District Court
for the Northern District of Illinois, Eastern Division
No. 86 C 2006—**Brian Barnett Duff**, *Judge*

This cause was heard on the record from the United States District Court for the Northern District of Illinois, Eastern Division, and was argued by counsel.

On consideration whereof, IT IS ORDERED AND ADJUDGED by this Court that the judgment of the said District Court in this cause appealed from be, and the same is hereby, AFFIRMED, with costs, in accordance with the opinion of this Court filed this date.

APPENDIX 2

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681 F.Supp. 530 (N.D. Ill. 1988)

R. Richard BASTIAN, III, et al., Plaintiffs,

v.

PETREN RESOURCES CORPORATION, et al., Defendants.

No. 86 C 2006.

United States District Court, N.D. Illinois, E.D.

March 7, 1988.

* * * * *

MEMORANDUM OPINION

BRIAN BARNETT DUFF, District Judge.

This case arises out of the sales of limited partnership interests in two Illinois oil and gas limited partnerships, Petren 1981A and Petren 1981B. Each plaintiff is a limited partner of one or both of these partnerships. The complaint alleges that defendants—the general partners of the partnerships along with their attorneys—violated federal securities laws as well as state statutes and common law, and engaged in a pattern of racketeering activity, through various material non-disclosures they made prior to the sales of the partnership interests. Defendants have moved to dismiss all seven counts of the complaint on the grounds that plaintiffs have failed to state a claim upon which relief may be granted in any of the counts. This court has jurisdiction pursuant to 28 U.S.C. § 1331. For the reasons set forth below, the motion to dismiss the complaint is granted.

FACTS

The complaint names corporate defendants, Petren Resources Corporation ("PRC") and Faestel Investments ("FI"), as co-general partners in the limited partnerships, individual defendant David J. Faestel ("Faestel"), as the officer, director and sole shareholder of FI and the Chairman of the Board and principal shareholder of PRC, the law firm McDermott, Will and Emery ("MWE"), as legal representative of Faestel and FI, and Brian S. Hucker, as a lawyer with MWE. According to the complaint, at some time in 1981 MWE and Hucker prepared "Offering Memoranda" for the two limited partnerships in order to solicit and sell partnership interests. The Offering Memoranda described the limited partnerships Petren 1981A and 1981B as oil and gas ventures, identified FI and Petren as co-general partners in the partnerships and named MWE as counsel for the partnerships. It also described Faestel, FI and Petren as "being qualified and experienced in oil and gas ventures," and "purport[ed] to disclose all material information about the limited partnerships, including information about the two general partners and their principals."

Plaintiffs claim that, after receiving and reading the Offering Memoranda, they each decided to, and did invest in one or both of the limited partnerships. They assert, however, that they would not have invested had the Offering Memoranda not knowingly "failed to disclose the following facts about the qualifications and prior experience of Faestel, FI and Petren:"

> (a) That in or about September, 1979, Faestel and [FI] were sued in federal court in Chicago by investors in a previous oil and gas venture they had promoted and had been charged in that lawsuit with violating federal and state securities laws;

(b) That Faestel and [FI] had defaulted in the payment of approximately $1,000,000 in loans they had obtained from the Northern Trust Company in connection with prior oil and gas ventures they had promoted; and

(c) That Petren was established by Faestel and [FI] solely to promote the Petren Oil and Gas Programs and that Petren was, in actuality, nothing more than the alter ego of Faestel and [FI].

The complaint further alleges that MWE and Hucker had represented Faestel and FI in the (non-disclosed) securities litigation and loan transactions, that all of the defendants knew about these problems at the time the Offering Memoranda were prepared and distributed, and that plaintiffs did not know of these problems at the time they purchased their partnership interests. Indeed, according to the complaint, plaintiffs only learned of them when, in 1984, plaintiff Ronald Rotunda became concerned about his investment in Petren 1981B and hired an attorney to investigate the limited partnerships.

Plaintiffs claim that, during the investigation Hucker told Rotunda's attorney that Rotunda was the only limited partner questioning the conduct of Faestel or the general partners, but that, in fact, "at the time Rotunda's attorney was conducting the investigation, there were at least two separate federal actions filed against Faestel and the general partners relating to the Petren Oil and Gas Programs." In any case, plaintiffs allege, by the time Rotunda's attorney had completed his investigation, "plaintiffs' investments in the Petren Oil and Gas Programs had become worthless."

Plaintiffs filed the instant lawsuit in March, 1986, alleging private rights of action under the following criminal statutes: Count I—§ 10(b) of the Securities and Exchange

Act of 1934, 15 U.S.C. § 78j(b) ("§ 10(b)") and Securities and Exchange Commission Rule 10b-5 ("Rule 10b-5"), 17 C.F.R. § 240.10-5; Count II—§ 17(a) of the Securities and Exchange Act of 1933, 15 U.S.C. § 77q(a) ("§ 17a") (Count II); Count III—the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. § 1961 et seq. ("RICO"); and, Count IV—the Illinois Consumer Fraud and Deceptive Business Practices Act, Ill.Rev.Stat. ch. 121½, § 261 et seq. Plaintiffs also alleged the following Illinois common law claims: Count V—breach of fiduciary duty; Count VI—fraud; and Count VII—against MWE and Hucker only, negligence.

In two sets of well-written and well-reasoned briefs,[1] defendants asserted a number of grounds for dismissing each of the five counts in the complaint. Plaintiffs, in equally articulate papers, countered each of the substantive arguments in turn. In addition, in the period after the motions became fully briefed, both sides promptly informed the court of new decisions which could bear on the resolution of the issues joined in the briefs. This court commends the attorneys involved in this case for their skillful advocacy of their clients' causes.

DISCUSSION

Count I

In Count I, plaintiffs seek to recover the losses on their investments in the limited partnerships on the grounds that defendants failed to disclose the earlier loan problems

[1] Faestel, FI and Petren jointly filed one motion to dismiss; MWE and Hucker together filed a separate motion to dismiss. With a few exceptions not relevant to this court's ruling, both motions raised the same grounds in seeking dismissal of the complaint.

and securities litigation. To recover under a § 10(b) or Rule 10b-5 private cause of action, plaintiffs must first prove that defendants violated the statute or the rule.

To do so, plaintiffs must establish the following:

(1) that defendants intentionally or recklessly;

(2) misrepresented or omitted to disclose

(3) material facts;

(4) in connection with the purchase or sale of a security.[2]

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[2] Section 10 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange—
>
> * * * * * *
>
> (b) To use or employ, in connection with the purchase and sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contrivance of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5 provides:

> It shall be unlawful for any person directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any scheme, device or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of circumstances in which they were made, not misleading, or
>
> (c) To engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Plaintiffs here ground their claim for relief on an alleged violation of Rule 10b-5(b).

Beck v. Cantor, 621 F.Supp. 1547, 1553 (D.C. Ill. 1985). *See also Harris v. Union Electric Co.*, 787 F.2d 355, 362 (8th Cir.), *cert. denied*, ____ U.S. ____, 107 S.Ct. 94, 93 L.Ed.2d 45 (1986); *Gochnauer v. A.G. Edwards & Sons, Inc.*, 810 F.2d 1042, 1046 (11th Cir. 1987).

Showing a § 10(b) or Rule 10b-5 violation is not, however, enough. To recover, plaintiffs must also prove that they justifiably relied on defendants' misrepresentations or omissions in making their investments and that the misrepresentations or omissions "caused" the losses. *Harris Trust and Savings Bank v. Ellis*, 810 F.2d 700, 706 (7th Cir. 1987). *See also Teamsters Local 282 Pension Trust Fund v. Angelos*, 762 F.2d 522 (7th Cir. 1985).

Defendants do not contest, for the purposes of the motion to dismiss, that plaintiffs have properly pled the elements of a § 10(b) or Rule 10b-5 violation. Nor do they challenge plaintiffs' contention that, because the claims here are predicated on material omissions, "reliance and 'causation in fact' are presumed." *Beck v. Cantor*, 621 F. Supp. at 1556. *See Affiliated Ute Citizens v. United States*, 405 U.S. 128, 153-54, 92 S.Ct. 1456, 1472, 31 L.Ed.2d 741 (1972); *Kademian v. Ladish Co.*, 792 F.2d 614, 627 (7th Cir. 1986) (in § 10(b) cases, "causation [in fact] and reliance are closely related"); *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1049 (7th Cir.) ("With materiality established, reliance in an omissions case is presumed."), *cert. denied*, 434 U.S. 875, 98 S.Ct. 225, 54 L.Ed.2d 155.

Nevertheless, defendants do insist that Count I must be dismissed because plaintiffs have failed to allege a second element necessary to establish legal causation in a § 10(b) case—that defendants' material omissions were causally linked to the loss in value of plaintiffs' investments. Stated differently, defendants claim that Count I

fails to state a claim upon which relief may be granted because, although plaintiffs have sufficiently pled "transaction causation"—that the nondisclosures "caused" plaintiffs to invest in Petren A and Petren B— they have not pled "loss causation"—that the nondisclosed information "caused" the subsequent decline in the value of the partnership interests.

The majority of courts to consider the issue have stated that "loss causation" is an essential element in a private action under § 10(b) or Rule 10b-5:

> [T]he causation requirement is satisfied in a Rule 10b-5 case only if the misrepresentation touches upon the reasons for the investment's decline in value. If the investment decision is induced by misstatements or omissions that are material and that were relied on by the claimant, but are not the proximate reason for his pecuniary loss, recovery under the Rule is not permitted.

Huddleston v. Herman & MacClean, 640 F.2d 534, 549 (5th Cir. 1981), *aff'd in part and rev'd in part on other grounds*, 459 U.S. 375, 103 S.Ct. 683, 74 L.Ed.2d 548 (1983); *Currie v. Cayman Resources Corp.*, 835 F.2d 780 (11th Cir. 1988); *Platsis v. E.F. Hutton & Co.*, 642 F. Supp. 1277, 1299-1300 (W.D. Mich. 1986), *aff'd*, 829 F.2d 13 (6th Cir. 1987). *See also Messer v. E.F. Hutton & Co.*, 833 F.2d 909, 924 (11th Cir. 1987) (Clark, J., concurring); *Zoelsch v. Arthur Andersen & Co.*, 824 F.2d 27, 35 n. 5 (D.C. Cir. 1987); *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 186 n. 16 (3d Cir. 1981) ("reliance [and thus 'causation in fact'] is necessary but not sufficient to establish [legal] causation]"), *cert. denied*, 455 U.S. 938, 102 S.Ct. 1427, 71 L.Ed.2d 648 (1982).

In at least one circuit, however, there is an exception to this rule:

> A plaintiff 'should not have to prove loss causation where the evil is not the price the investor paid for the security, but the broker's fraudulent inducement of the investor to purchase the security.'

Kafton v. Baptist Park Nursing Center, 617 F.Supp. 349, 350 (D. Ariz. 1985), *quoting, Hatrock v. Edward D. Jones & Co.*, 750 F.2d 767, 773 (9th Cir. 1984). Furthermore, although the Second Circuit has stated repeatedly that to establish causation for purposes of § 10(b), a plaintiff must "show both *loss causation* . . . and *transaction causation*," *Bennett v. United States Trust Co. of New York*, 770 F.2d 308, 313 (2d Cir. 1986), *cert. denied*, 474 U.S. 1058, 106 S.Ct. 800, 88 L.Ed.2d 776 (1987), *quoting, Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 380 (2d Cir. 1974), *cert. denied*, 421 U.S. 976, 95 S.Ct. 1976, 44 L.Ed. 2d 467 (1975), its recent decision in *Manufacturer's Hanover Trust Company v. Drysdale Securities Corp.*, 801 F.2d 13 (2d Cir. 1986), *cert. denied*, ____ U.S. ____, 107 S.Ct. 952, 93 L.Ed.2d 1001 (1987), at least implicitly calls those decisions into question.[3]

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[3] Although the Court in *Manufacturer's Hanover* stated that "loss causation" remains an essential element in § 10(b) cases, it then proclaimed that "loss causation" can be established by showing the defendants could have reasonably foreseen that their misstatements would induce the plaintiffs to invest. While that is, to be sure, a *proximate cause* requirement, it most certainly is not a "*loss causation*" requirement, at least not "loss causation" in the sense that term has been used by other courts.

Indeed, by equating "loss causation" with "proximate causation," the court oversimplified and confused the central issue involved in these cases. The question is not whether plaintiffs must establish "proximate" as well as "but-for" cause in § 10(b) cases; proximate cause is always a prerequisite to recovery. *See First Interstate Bank of Nevada v. Chapman & Cutler*, 837 F.2d 775 (7th Cir. 1988) (dismissing § 10(b) case against defendants for alleged fraud in connection with sale of McCormick A bonds because al-

(Footnote continued on following page)

Nevertheless, this court has determined that plaintiffs here must allege "loss causation" if they are to survive a motion to dismiss, for a number of reasons.

First, this court must give deference to the Third Circuit's recent ruling affirming a district court's dismissal—for failure to allege "loss causation"—of a § 10(b) claim against the same defendants, and grounded on the same facts, as the instant case. *See Sims v. Faestel*,[4] 683 F. Supp. 1281 (E.D. Pa. 1986), *aff'd mem.*, 813 F.2d 399 (3d Cir. 1987).

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[3] *continued*

leged fraud was a "but-for" but not a "proximate" cause of plaintiff's loss on purchase of McCormick B bonds, which defaulted after the funds raised from their issuance were used to repay the McCormick A bond holders). Rather the question is whether the plaintiff must prove not only that the violation proximately caused the investment decision, but that it proximately caused the economic harm as well.

The oversimplification in *Manufacturer's Hanover* led defendants here to argue erroneously that that ruling supports their "loss causation" argument. In fact, the *dicta* in that case—that to show loss causation plaintiffs must prove that the *investment decision* "was either a direct result of the misleading statement or one which could reasonably have been foreseen," *id.* at ¶ 94,394; *see infra* n. 6—would, if adopted by this court, defeat the instant motions to dismiss.

[4] Defendants have argued that, because *Sims* was brought as a class action on behalf of all of the limited partners in the Petren partnerships, this court should apply collateral estoppel to the issues resolved in that case. The district court in *Sims*, however, dismissed the case without certifying the class, so issue preclusion is inappropriate. Nevertheless, the fact that the decision was based on nearly identical questions of fact and law, and was affirmed by the Third Circuit, mandates that this court give it deference here. *Premier Electric Construction Co. v. N.E.R.C.*, 814 F.2d 358, 367 (7th Cir. 1987); *Colby v. J.C. Penney Co.*, 811 F.2d 1119, 1123-24 (7th Cir. 1987).

Second, while the Seventh Circuit has never squarely addressed the issue,[5] two district courts in this circuit have recently dismissed § 10(b) claims for failing to allege "loss causation". *See Rankow v. First Chicago Corporation*, 678 F.Supp. 202 (N.D. Ill. 1987); *TFG, Inc. v. Sullivan*, No. 86-4176, slip op. (N.D. Ill. Oct. 20, 1986) [Available on WESTLAW, 1986 WL 11996].

Third, the courts which have rejected a "loss causation" requirement have done so in cases involving a particular and special form of § 10(b) violation—stock broker "churning" of client accounts. *See, e.g., Hatrock v. Edward D. Jones & Co.*, 750 F.2d 767 (9th Cir. 1984); *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167 (2d Cir. 1970). In these cases, stock brokers cheat their clients out of commissions by fraudulently inducing them to purchase excessive amounts of stock. The fraud generally involves misrepresentations as to the brokers' skills in picking winning stocks or the potential gains available to the customers through a particular investment strategy. *See, e.g., Marbury Management Inc. v. Kohn*, 629 F.2d 705 (2d Cir.) (trainee at brokerage firm fraudulently misrepresented himself as a "portfolio management specialist" and thereby persuaded plaintiffs to purchase highly speculative stocks), *cert. denied*, 449 U.S. 1011, 101 S.Ct. 566, 66 L.Ed.2d 469 (1980). Courts have held these brokers accountable not only for their commissions, but also for the

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5 The Seventh Circuit has used the term "loss causation" in referring to the requirement that a § 10(b) or Rule 10b-5 plaintiff prove that he suffered a financial loss as a result of the violation. *See Kademian v. Ladish Co.*, 792 F.2d 614, 627 (7th Cir. 1986). The court did not address the requisite causal nexus between the alleged violation and the harm suffered. *Compare Harris Trust and Savings Bank v. Ellis*, 810 F.2d 700 (7th Cir. 1987) (same proposition without term "loss causation").

customers' losses on their investments, despite the fact that it was the decline in the overall market, not the misinformation which caused the stocks' prices to fall.[6] *See Hatrock v. Edward D. Jones & Co., supra*; *Chasins v. Smith, Barney & Co., supra*; *Marbury Management Inc. v. Kohn, supra*; *But see In re Catanella and E.F. Hutton & Co.*, 583 F.Supp. 1388 (E.D. Pa. 1984).

These cases provide weak authority for rejecting a "loss causation" requirement in the instant case, for two reasons. First, the courts permitting full recovery of the losses appear (at least implicitly) to have predicated their decisions on the theory that, while the brokers' misrepresentations did not cause the stocks' prices to fall, they did cause the customers to overestimate—on the basis of their brokers' "advice"—the value of their investments at the time of the purchases. *See Bennett v. United States Trust Co. of New York*, 770 F.2d at 314 (explaining *Marbury Management:* "In essence, the stock in question did not have the value represented by the broker."). Under this theory, the subsequent decline in the stocks' prices served, in effect, as proxies for the "losses" which the clients suffered at the *time of their investments*—losses which clearly fall within the parameters of the "loss causation" requirement. *See, e.g., Sharp v. Coopers & Lybrand*,

[6] Although *Manufacturer's Hanover Trust Company v. Drysdale Securities Corp., supra*, was not a broker case, it does not necessarily deviate from this rule. Although, as noted *supra* n. 3, the Court there did not require "loss causation" as that term has been used in this opinion, the existence of "loss causation" in that case was clear. *See Zoelsch v. Arthur Andersen & Co.*, 824 F.2d at 35 n. 5 (explaining *Manufacturer's Hanover* as requiring *both* lost causation and transaction causation). Accordingly, the narrow holding of that case was simply that plaintiff had sufficiently established "transaction causation"—that is, a proximate causal nexus between the § 10(b) violation and the subsequent purchase.

649 F.2d 175 (3d Cir. 1981) (where misinformation provided by defendant results in plaintiff paying too much, or receiving too little for his stock, "loss causation" exists), *cert. denied*, 455 U.S. 938, 102 S.Ct. 1427, 71 L.Ed.2d 648 (1982). Thus, the churning cases may not even represent exceptions to the loss causation requirement.

Moreover, to the extent that these cases cannot be reconciled with those requiring "loss causation," they represent an unwarranted break with traditional notions of legal causation. In his dissent in *Marbury Management*, Judge Meskill refused to read the majority's imposition of liability against the defendant as anything but a complete rejection of the "loss causation" requirement. He then proceeded to condemn the majority's result, in an opinion recently cited with approval by the Seventh Circuit:

> I share my colleague's condemnation of [defendant's] misconduct and express no view as to whether recourse may lie in an appropriate court under a theory more feasible than the one advanced by plaintiffs. In approving [defendant's] present sanction, however, the majority is more righteous than right, for its decision abandons the traditional understanding of causation in the context of the sale of securities induced through misrepresentation, disregards governing precedent and extends the reach of § 10(b) beyond that of its common law antecedent to provide for recovery in cases in which federal policies are offended by such expansion.

Marbury Management Inc. v. Kohn, 629 F.2d at 717 (Meskill, J., dissenting), *cited with approval*, *First Interstate Bank of Nevada v. Chapman & Cutler*, 837 F.2d 775 (7th Cir. 1988).

What Judge Meskill said in a case involving a stock broker selling stocks to his less experienced customers

applies with even greater force in cases involving sales of partnership interests in obviously speculative capital ventures. *See Platsis v. E.F. Hutton & Co., supra.* Without condoning securities fraud in any context, this court can see no basis for "transform[ing] the perpetrator of the [securities] fraud into 'an insurer of the investment, responsible for an indefinite period of time for any and all manner of unforeseen difficulties which may eventually beset the [investment].'" *In re Catanella and E.F. Hutton & Co. Securities Litigation*, 583 F.Supp. at 1417, *quoting Marbury Management*, 629 F.2d at 718 (Meskill, J., dissenting). Accordingly, this court will adhere to the traditional common law rule that "if false statements are made in connection with the sale of corporate stock, losses due to a subsequent decline of the market, or insolvency of the corporation, brought about by business conditions or other factors in no way related to the representations, will not afford any basis for recovery." Prosser, *Law of Torts* § 100 at 732 (4th ed.) (footnotes omitted).

Plaintiffs here have not even attempted to plead that the information defendants allegedly omitted from the Offering Memoranda caused the decline in their Petren A and Petrin B partnerships interest. Perhaps the ventures became worthless because defendants were incompetent or irresponsible; if so, plaintiffs may be able to plead, in an amended complaint, a causal nexus between the non-disclosures and their economic loss. On the other hand, the investments may be worthless for reasons completely unrelated to the non-disclosures; in that case, an amended complaint would not only fail, but might be subject to sanctions. Whatever the case, one thing is clear: Count I of the complaint as it now stands must be dismissed without prejudice.

Count II

Count II alleges the same facts as Count I but seeks relief under § 17(a). This court will not tarry long in dispensing with this claim. First, for the reasons set forth most recently by the Ninth Circuit in *In re Washington Public Power Supply System Securities Litigation*, 823 F.2d 1349 (9th Cir. 1987) (*en banc*), and already articulated by a number of district judges in this circuit, *e.g.*, *Beck v. Cantor*, 621 F.Supp. 1547, 1553 (D.C. Ill. 1985) (Rovner, J.), this court holds that there is no implied private right of action under § 17(a). Moreover, even were such an implied right of action available, plaintiffs could not state a claim for relief under it here. *See Teamsters Local 282 Pension Trust Fund v. Angelos*, 762 F.2d 522, 531 (7th Cir. 1985) (where allegations under § 10(b) and § 17(a) overlap, the § 17(a) claim "adds nothing to the plaintiff's arsenal"). Accordingly, Count II will be dismissed with prejudice.

Count III

In Count III, plaintiffs seek treble damages under RICO, 18 U.S.C. 1964(c),[7] on the grounds that the violations of § 10(b) and § 17(a) alleged in Counts I and II constitute a "pattern of racketeering activity,"[8] that through this

[7] 18 U.S.C. § 1964(c) provides:

> Any person injured in his business or property by reason of a violation of § 1962 of this chapter may sue thereon in any United States district court and shall recover threefold the damages he sustains and the cost of the suit including a reasonable attorney's fee.

[8] 18 U.S.C. § 1961(5) states that:

> a "pattern of racketeering activity" requires at least two acts of racketeering activity, one of which occurred within ten years after the effective date of this chapter and the last of which

(Footnote continued on following page)

"pattern of racketeering activity" defendants conducted the affairs of the Petren IA and Petren IB "enterprises," and that plaintiffs were damaged "by reason of" this activity.

Defendants have moved to dismiss on three grounds: First, the insufficiency of the § 10(b) and § 17(a) claims means that defendants have failed to sufficiently plead *any* predicate acts of racketeering activity; second, even if plaintiffs have properly pled securities violations, they have pled only a single violation with respect to each Petren "enterprise" and thus have failed to properly allege a RICO violation; and, third, even if plaintiffs have sufficiently alleged a RICO violation, they lack standing because they have not alleged how they were injured by it.

The first and third arguments indicate that defendants misconstrue the interaction between the securities laws and the RICO claims predicated on them. As defendants themselves argued, plaintiffs failed to state a claim under Counts I and II not because defendants did not violate the securities laws, but rather because courts, in implying private rights of action under these laws, have imposed an additional "loss causation" requirement. *See United States v. Newman*, 664 F.2d 12 (2d Cir. 1981) ("It

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[8] *continued*

> occurred within ten years (excluding any period of imprisonment) after the commission of a prior act of racketeering activity.

The term "racketeering activity" encompasses a broad scope of criminal activity including "any act 'chargeable' under several generically described state criminal laws, any act 'indictable' under numerous specific federal criminal provisions including mail and wire fraud, and any 'offense' involving bankruptcy or securities fraud or drug-related activities that is 'punishable' under federal law." *Sedima, S.P.R.L. v. Imrex Co.*, 473 U.S. 479, 105 S.Ct. 3275, 87 L.Ed.2d 346 (1985) (summarizing 18 U.S.C. § 1961(1)).

is only because the judiciary has created a private cause of action for damages [under § 10(b)] the "contours" of which are not described in the statute, that standing in such cases has become a pivotal issue."), *cert. denied*, 464 U.S. 863, 104 S.Ct. 193, 78 L.Ed.2d 170 (1983).

This judicially-imposed limitation on such rights of action simply does not apply to the statutorily-created RICO claims. *See Sedima, S.P.R.L. v. Imrex Corp.*, 473 U.S. 479, 105 S.Ct. 3275, 87 L.Ed.2d 346 (1985). To recover under § 1964(c), plaintiffs need only establish that they were injured "by reason of" a RICO violation. And to prove a RICO violation, plaintiff need only prove a pattern of "fraud in the sale of securities." They need not allege nor prove that they could actually recover in a private action under the securities laws.

Thus, assuming for the moment that the alleged violations of §§ 10(b) and 17(a) constituted a "pattern of racketeering activity," plaintiffs need only allege, for the purposes of their RICO claim, that the securities violations "caused" them to purchase stock that subsequently declined in price. *Haroco, Inc. v. American National Bank & Trust of Chicago*, 747 F.2d 384 (7th Cir. 1984), *aff'd*, 473 U.S. 606, 105 S.Ct. 3291, 87 L.Ed.2d 437 (1985). This much they have clearly done.[9] Accordingly, defendants' first and third arguments for dismissing the RICO claim must fail.

Defendants' second argument for dismissing Count III, however, will carry the day. In this court, plaintiffs have alleged that defendants conducted each Petren partner-

[9] Defendants conceded in the first part of their brief that plaintiffs had pled "transaction causation."

ship through a single distinct act of securities fraud[10]—and that the two acts, taken together, constitute a "pattern of racketeering activity" in violation of § 1962(c). Defendants maintain that, because plaintiffs have identified each Petren partnership as a separate enterprise, and because in order to allege a § 1962(c) violation, plaintiffs must point to a single enterprise which defendants conducted through a pattern of racketeering activity, this count fails to state a RICO claim. Defendants are clearly correct here.

While considerable debate has focused on whether and when two predicate racketeering acts are sufficiently "related and continuous" to constitute a "pattern of racketeering activity," there has never been any doubt that, to state a claim under § 1962(c), a RICO plaintiff must identify a single enterprise, the affairs of which the defendant conducted through a pattern of such activity. Indeed, the words of the statute itself make this clear:

> It shall be unlawful for any person employed by or associated with *any enterprise* . . . to conduct or participate . . . in the conduct of *such enterprise's* affairs through a pattern of racketeering activity. . . .

18 U.S.C. § 1962(c) (emphasis added). *See also Sedima, S.P.R.L. v. Imrex Corp.*, 473 U.S. 479, 105 S.Ct. 3275, 87 L.Ed.2d 346 (1985) ("the essence of the [§ 1962(c)] vio-

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[10] Although the complaint attempts to identify two predicate "acts" with respect to each Petren enterprise by alleging each securities violation twice—once as a violation of § 10(b), then as a violation of § 17(a)—plaintiffs do not pursue this position in their response brief. They are right not to do so. A single criminal act clearly cannot constitute a "pattern of racketeering activity," regardless of how many statutes it violates, if for no other reason than that it cannot possibly satisfy the "continuity" prong of the "relationship plus continuity" requirement.

lation is the commission of the [predicate] acts in connection with the conduct of *an enterprise*") (emphasis added).

Because plaintiffs have not alleged a single enterprise, the affairs of which defendant conducted through two or more acts of racketeering activity, this court will grant defendants' motion to dismiss Count III. However, because it is possible that plaintiffs may yet be able to remedy the defect in this count, the dismissal will be without prejudice.

Counts IV-VII

Counts IV through VII are state law claims brought pursuant to this court's pendent jurisdiction. Since the federal claims have all been dismissed, this court has decided not to exercise its discretion to hear these claims and will instead dismiss them without prejudice. Should plaintiffs seek to file an amended complaint, they can reallege the state law claims at that time.

CONCLUSION

Count II is dismissed with prejudice. The rest of the complaint is dismissed without prejudice.

APPENDIX 3

699 F.Supp. 161 (N.D. Ill. 1988)

R. Richard BASTIAN, III; B.P. Loughridge; Ronald D. Rotunda; Marcia Rotunda; General Synergy Investments, an Oklahoma partnership; Gabriel Fernandez; J. Mahar; CMF Associates, an Illinois partnership; Alfred J. Hendron; and M.T. Davidson, Plaintiffs,

v.

PETREN RESOURCES CORPORATION, an Illinois corporation; Faestel Investments, Inc., an Illinois corporation; David J. Faestel; McDermott, Will & Emery, a partnership; and Brian Hucker, Defendants.

No. 86 C 2006.

United States District Court,
N.D. Illinois, E.D.

Oct. 28, 1988.

* * * * * *

MEMORANDUM OPINION

BRIAN BARNETT DUFF, District Judge.

On March 7, 1988, this court dismissed the seven-count complaint brought by R. Richard Bastian III and others against Petren Resources Corporation; Faestel Investments, Inc. ("FII"); David J. Faestel; McDermott, Will & Emery; and Brian Hucker. See *Bastian v. Petren Resources Corp.*, 681 F.Supp. 530 (N.D. Ill. 1988). All but one of the original counts were dismissed without prej-

udice. The plaintiffs have corrected some of the defects of their original complaint, added a new count, dropped defendant Hucker, and submitted an Amended Complaint.

In Count 1 of their new complaint, the plaintiffs allege a violation of § 1962(c) of the Racketeer Influenced and Corrupt Organizations Act ("RICO"), codified at 18 U.S.C. § 1961 et seq. (1982). In Count 2 the plaintiffs allege that Petren violated § 1962(a) of the RICO statute, while in Counts 3-6 they allege various claims under Illinois law. The defendants have moved for dismissal of Counts 1 and 3-6 of the Amended Complaint under rule 12(b)(6) Fed.R. Civ.P. Additionally, defendant Petren moves for dismissal of Count 2 for plaintiff's failure to comply with Rule 9(b), Fed.R.Civ.P.

The facts alleged in the Amended Complaint are essentially the same as those alleged in the original complaint, which this court canvassed in its earlier opinion. The gravamen of the RICO claim stated in Count 1 is that the defendants drafted an Offering Memorandum that omitted material information. The plaintiffs claim that had the Memorandum contained this information, they would not have invested in limited partnership shares sold through the Memorandum, shares which declined sharply in value. Count 1 concludes: "Plaintiffs have been injured in their business and property by reason of the defendant's [sic] violations of 18 U.S.C. § 1962(c) and (d)." Complaint at ¶ 35.

The defendants contend that the plaintiffs have not alleged causation sufficiently in Count 1 to recover under 18 U.S.C. § 1964(c), the civil damages provision of RICO. Section 1964(c) provides:

> Any person injured in his business or property by reason of a violation of section 1962 of this chapter may sue therefor in any appropriate United States

> district court and shall recover threefold the damages he sustains and the cost of the suit, including a reasonable attorney's fee.

The defendants draw this court's attention to the words "by reason of." They argue that these words contain requirements of "but for" and "proximate" causation, so familiar from the law of torts. See W. Page Keeton, et al., The Law of Torts §§ 41-42 (5th ed. 1984). The defendants submit that the plaintiffs have not alleged proximate causation.

The proper place to begin any inquiry into what a statute requires (although one would not know it from the briefs submitted in this case) is the language of the statute itself. Section 1964(c)'s phrase "by reason of" does not explicitly require proximate causation. It could very well require only cause in fact, if reduced to its most simple form. The context of the phrase does not cast light on its meaning, and so this court must rely on other means of construing it. One method is to determine if either construction would render § 1964(c) unreasonable, but this method does not help: reading "by reason of" to contain only "but for" causation would be reasonable, given Congress's desire in enacting RICO to fight organized crime aggressively. See *Sedima, S.P.R.L. v. Imrex Co.*, 473 U.S. 479, 498-99, 105 S.Ct. 3275, 3285-86, 87 L.Ed. 2d 346 (1985) (reviewing legislative purposes of RICO). On the other hand, it is not inconceivable that Congress would have required proximate causation, given the widespread use of the concept in civil law.

The plain words "by reason of" in § 1964(c), their context, and the reasonableness of the two suggested constructions of the phrase do not exhaust the tools of this court for interpreting the statute. This court has further recourse to the history of the Organized Crime Control

Act of 1970, Pub.L. 91-452, 84 Stat. 922, the act that introduced RICO into the federal system. As the Supreme Court noted in *Sedima*, 473 U.S. at 487-88, 105 S.Ct. at 3280-81, Congress modeled RICO's treble damages provisions on similar civil remedies provided under the federal antitrust laws. While Congress never directed its attention specifically to RICO's "by reason of" language while considering the Organized Crime Control Act, see Organized Crime Control Act of 1970, H.Rep. No. 91-1549, 91st Cong., 2d Sess. (Sept. 30, 1970) U.S. Code Cong. & Admin. News 1970, p. 4007 (reporting House version of S. 30, which contained RICO's civil damages provision); 116 Cong. Rec. 35191-217 (Oct. 6, 1970) (House debate on Organized Crime Control Act); *id.* at 35287-364 (Oct. 7, 1970) (conclusion of House debate); *id.* at 36281-96 (Oct. 12, 1970) (Senate debate), members of both houses repeatedly acknowledged that they were mobilizing "both the criminal and civil mechanisms of the Sherman Act and other antitrust statutes against the barons of organized crime." *Id.* at 35201 (Rep. Poff). See also *id.* at 35196, 35197, 352000 (Reps. Celler, McCulloch, and Rodino, to the same effect); *id.* at 36294, 36296 (Sens. McClellan and Dole, to same effect).

These statements suggest that the antitrust laws are instructive as to the causation required under RICO. While the Court in *Sedima* noted that there are some indications in the legislative precursors of RICO that the courts should not rely too heavily on the antitrust laws in interpreting § 1964(c), see *Sedima*, 473 U.S. at 498-99, 105 S.Ct. at 3285-86 (quoting comments of American Bar Association in 1969 on a proposed RICO-like amendment to the Sherman Act, warning that the strict standing and proximate cause requirements of the antitrust laws would hamper efforts to combat organized crime), these historical

references should not prevent a court from referring to the antitrust laws altogether. Congress did not ignore the antitrust laws, and neither should this court.

The most direct antitrust analogy to RICO is found in § 4 of the Clayton Act, 15 U.S.C. § 15 (1982). This section contains the exact "by reason of" language found in RICO. The Supreme Court has interpreted this language to impose, for lack of a better term, a "proximate cause" requirement on Clayton Act treble damages claims. See *Associated General Contractors v. Carpenters*, 459 U.S. 519, 529-37, 103 S.Ct. 897, 903-08, 74 L.Ed.2d 723 (1983). In *Carpenters*, the Court traced the history of the common law's influence upon the Clayton Act and concluded that, in enacting the broad remedial provisions of the Clayton Act, " 'Congress did not intend to allow every person tangentially affected by an antitrust violation to maintain an action to recover threefold damages for the injury to his business or property.' " *Id.* at 535, 103 S.Ct. at 907, quoting *Blue Shield of Virginia v. McCready*, 457 U.S. 465, 477, 102 S.Ct. 2540, 2547, 73 L.Ed.2d 149 (1982). Congress intended instead to include those limitations of the common law which traditionally have limited the scope of a tortfeasor's liability. While the Court hesitated to employ the words "proximate cause" (or even the seemingly infinite variations of that term, see *Carpenters*, 459 U.S. at 535 n. 32, 103 S.Ct. at 907 n. 32), it was clear in its holding that the Clayton Act required the federal courts to examine, "as was required in common-law damages litigation in 1890, . . . the plaintiff's harm, the alleged wrongdoing by the defendants, and the relationship between them." *Id.* at 535, 103 S.Ct. at 907.

Like the Court in *Carpenters*, this court hesitates to use the term "proximate cause" too loosely. Nevertheless, it is appropriate for this court to evaluate the plaintiff's

harm, the alleged wrongdoing of the defendants, and the relationship between them in civil RICO actions brought under § 1964(c), as this court would in a case brought under § 4 of the Clayton Act. While the court believes that it is the first court in this circuit to find that § 1964(c) requires a showing of proximate cause, it should be noted that the Seventh Circuit suggested it in dicta in *Haroco v. American Nat. B. & T. Co. of Chicago*, 747 F.2d 384, 398 (7th Cir. 1984):

> This holding by no means renders superfluous the requirement in section 1964(c) that the plaintiff be injured "by reason of" a violation of section 1962. As we read this "by reason of" language, it simply imposes a proximate cause requirement on plaintiffs. The criminal conduct in violation of section 1962 must, directly or indirectly, have injured the plaintiff's business or property. A defendant who violates section 1962 is not liable for treble damages to everyone he might have injured by other conduct, nor is the defendant liable to those who have not been injured. This causation requirement might not be subtle, elegant or imaginative, but we believe it is based on a straightforward reading of the statute as Congress intended it to be read.

More recently, the Seventh Circuit has suggested that whenever Congress creates a private right of action for injuries sustained "by reason of" a violation of state or federal law, it obliges a plaintiff to demonstrate a causal connection "roughly equivalent to the causal connection required to establish common law tort liability"—absent an express indication to the contrary. See *Zepik v. Tidewater Midwest, Inc.*, 856 F.2d 936, 942 (7th Cir. 1988) (interpreting § 23(a) of Consumer Products Safety Act, codified at 15 U.S.C. § 2072(a)). This court thus believes that it is proper for it to look for "proximate cause" in claims brought under § 1964(c) of RICO.

Proceeding with this in mind, the court finds that the plaintiffs have failed to allege proximate cause in Count 1. The plaintiffs allege that they purchased limited partnerships interests and that those interests are now worthless. The plaintiffs contend further that the defendants violated §§ 1962(c)-(d) by marketing the partnership interests, using an Offering Memorandum that omitted material information in violation of § 10(b) of the Securities and Exchange Act of 1934, 15 U.S.C. § 78j(b), Securities and Exchange Commission Rule 10b-5, 17 C.F.R. § 270.10-5 (1988), and § 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a). The Amended Complaint, however, fails to take the matter any further. As the Court noted in *Carpenters*, proper causation requires a relationship between the alleged violation of law and the harm that resulted from the violation. Here, the plaintiffs allege no relationship beyond "but for" causation: had they known the facts omitted from the Offering Memorandum, they would not have purchased the partnership interests.

Of course, under the Federal Rules of Civil Procedure, plaintiffs need not allege each and every fact relevant to their complaint. Nevertheless, this court cannot find even a suggestion of a relationship between the harms claimed and the securities law violations alleged here sufficient to demonstrate proximate causation. According to the Amended Complaint, the defendants failed to disclose that (1) they faced lawsuits in connection with other ventures that they had promoted; (2) Faestel and FII had defaulted on loans obtained with respect to these other ventures; (3) Petren had been established solely to promote limited partnerships and had no previous operating history; (4) Petren was the alter ego of Faestel and FII; (5) Faestel had "extreme financial difficulties"; (6) Petren had fired its president and chief petroleum engineer for incompe-

tence and recklessness; (7) Faestel and McDermott, Will failed to disclose their knowledge that the limited partnerships had little chance to realize a return on investment; and (8) Faestel and McDermott, Will misrepresented the potential earnings and returns on investment of the 1981A and 1981B Petren limited partnerships. See Amended Complaint at ¶¶ 17, 34.

Amidst all of these allegations, one cannot find the crucial element of a § 1964(c) claim: an allegation that any of these defendants' *omissions* lead to the decline in the value of the plaintiffs' investments. Some of the things that were the subject of the omitted material might have been relevant to the loss: for example, if Petren's allegedly incompetent and reckless president and petroleum engineer sank Petren's capital into dry holes, Petren's limited partners could legitimately connect *that* act with the loss that they suffered. But that is not what the plaintiffs do here. Instead, they claim that by the defendants' silence, Petren lost money. Silence could mean disaster in any number of businesses—broadcasting, for example—but the court fails to understand how it was disastrous in this case.

The plaintiffs contend that this court already resolved the issue of causation in its previous opinion. See *Bastian*, 681 F.Supp. at 537. There this court decided that RICO did not impose a requirement of "loss causation" on § 1964(c) claims, unlike that imposed on claims brought under § 10(b) of the Securities and Exchange Act. The loss causation requirement of § 10(b) is fairly close to the traditional notion of proximate cause. Both concepts involve an examination of the relationship between the alleged violation of the law and the loss claimed to have resulted from the violation. See *id.* at 533-36. This court stands by its earlier decision that RICO does not require loss

causation but as demonstrated above, RICO requires proximate causation. When the RICO violation is built upon a foundation of § 10(b) claims, in most cases the failure to prove loss causation under § 10(b) will result in a failure to prove proximate causation under § 1964(c) of RICO. That is the case here.

This court thus dismisses Count 1 for failure to state a claim. As for Count 2, it names only one defendant, Petren. Petren has not raised the proximate cause argument with respect to Count 2 (it felt content with an objection to the plaintiffs' lack of a particular allegation of fraud), but this court believes that Petren should have raised the argument. Count 2 suffers from the same defect as Count 1, differing only in that Count 2 states that Petren received income from the allegedly illegal securities activity outlined in Count 1 to injure the plaintiffs in their business and property. See Amended Complaint, Count 2 at ¶¶ 29-33. The plaintiffs do not suggest, however, how Petren's receipt of income led to a loss in the value of their interests in Petren. In most businesses, the receipt of income by an entity usually enriches the entity's owners. This court believes that, absent further allegation, Count 2 does not state a sufficiently close causal relationship between Petren's receipt of allegedly illegal income and the plaintiffs' losses.

This court thus dismisses Count 2 for failure to state a claim.* As for Counts 3-6, the defendants suggest that

* In *Doe on Behalf of Doe v. St. Joseph's Hosp.*, 788 F.2d 411, 414-16 (7th Cir. 1986), the Seventh Circuit noted that *sua sponte* dismissals for failure to state a claim upon which relief can be granted are permitted "so long as a sufficient basis for the court's action is apparent from the plaintiff's pleading." Such dismissals are a proper means of shaping litigation, and are disfavored only

(Footnote continued on following page)

this court should exercise its pendent jurisdiction and dismiss these counts for the plaintiffs' failure to state any claim. The defendants acknowledge that this would be an unusual practice for a federal court. Typically, the dismissal of federal claims ends federal jurisdiction over a case, and so it is the usual practice of the federal courts to dismiss any pendent state claims for lack of jurisdiction once the federal claims are gone. A court will retain jurisdiction over state claims only in exceptional circumstances, such as those in *Graf v. Elgin, Joliet and Eastern Ry. Co.*, 790 F.2d 1341 (7th Cir. 1986). In *Graf*, the Seventh circuit reviewed the decision of a federal district court to dismiss a single-count complaint on the merits, even though it ultimately appeared that the count arose under Illinois law. The Seventh Circuit upheld the district court's decision, partly for reasons of judicial economy. The court noted that a federal court should retain jurisdiction over state claims after dismissal of all federal claims in cases "where substantial judicial resources have already been committed, so that sending the case to another court will cause a substantial duplication of effort." *Id.* at 1347-48.

This case does not present the same situation as *Graf*, or even a close analogy. In *Graf*, the district court had ruled on the original two-count complaint filed in the case, saw its decision reviewed and reversed in part by the Seventh Circuit, and had received the single remaining count on remand. Further, that count contained mixed

* *continued*

when the court fails to give the parties notice or an opportunity to be heard. In this case, the plaintiffs had notice and a sufficient opportunity to be heard on the issue underlying this court's dismissal of Count 2, the plaintiffs' failure to allege proximate cause. It is the same question that the defendants raised as to Count 1.

questions of state and federal law, so that it was not clear at first blush that it arose entirely under Illinois law. The questions of Illinois law were also similar to those that would have been reached if federal law applied, mostly questions of fair labor practices.

None of the elements that persuaded the *Graf* court to retain jurisdiction is present here. First, unlike *Graf*, this case has not proceeded beyond the pleadings. Neither party has presented motions for summary judgment, motions that typically involve a greater commitment of judicial resources than those expended on motions to dismiss. Neither party has appealed any of this court's decisions in this case, and so this court does not have the benefit of a higher federal court's familiarity with the facts of this case. Second, Counts 3-6 clearly arise under Illinois law. They are labelled as such, and no questions of federal law emerge from them. The defendants' objections to them rest entirely on points of Illinois law. Last, the objections raised to Counts 3-6 have very little to do with the issue canvassed in this opinion, proximate causation. Hence, while having this court resolve the defendants' objections to Counts 3-6 would save the defendants time and money—particularly if the plaintiffs later choose to file their complaint in the Illinois courts—the focus of the *Graf* decision is savings to the judiciary. It probably would take a state court less time to resolve the state law questions raised by the defendants with respect to Counts 3-6, and so this court will decline the opportunity to do the state court's work.

Therefore, this court dismisses Counts 1 and 2 for failure to state a claim. This court also dismisses Counts 3-6 for lack of jurisdiction.